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The thing which is needed to secure healthy conditions is the most speedy and complete adaptation possible of the structure of production to the proportion between the demand for consumers' goods and the demand for producers' goods as determined by voluntary saving and spending. If the proportion as determined by the voluntary decision of individuals is distorted by the creation of artificial demand, it must mean that part of the available resources is again led into a wrong direction.

— Friedrich A. Hayek, *Prices and Production*, 1931

WHAT WENT WRONG?

For policymakers, economists, investors and the public in general, it was completely unexpected, shocking news. We are referring to the Bureau of Labor Statistics' report about job growth in July. The measly 32,000 new jobs created fell drastically short of a consensus forecast of 230,000 and higher. Even this paltry gain owed its existence entirely to major downward revisions for the prior two months.

Just three weeks earlier, in mid-July, the Federal Reserve had submitted its semiannual Monetary Policy Report to Congress, providing its forecast for GDP growth, inflation and unemployment through the end of 2005.

Page after page, it was nothing but sunshine. Year-over-year growth in GDP would top out at about 4.8% this year, before drifting down to 3.8% next year. The core rate of inflation was seen within a range of 1.5–2%. With GDP growth slightly in excess of its underlying growth potential, unemployment would drift lower from the current 5.6% to about 5.1%.

It is near-perfect performance for the U.S. economy as far as the eye can see. The basic assumption, of course, is, as always, that U.S. economic fundamentals are the best in the world. The minutes of the Federal Open Market Committee's policy meeting provided a more detailed rationale for this euphoric assessment. The apparent primary, crucial consideration is the conviction that the rich monetary and fiscal stimuli of the second half of last year has been effective in providing the economy with the necessary traction for self-sustaining, strong growth.

The second main optimistic assumption about the economy is its excellent profit performance during 2002–03. According to the consensus reports, profit margins are back to their heights during the boom. The implicit conclusion is that this ensures continued strong business fixed investment. Altogether, this would finally bolster job and income growth, offsetting any possible negative effects that higher interest rates may have on the housing market.

Manifestly, the policymakers at the Fed have convinced themselves that the economy is finally growing under its own steam. It became the Fed's new password that under these conditions it was necessary to lift the federal funds rate from its emergency level of 1% to a more normal level. Moving at a "measured" pace to a "neutral" policy stance became the Fed's publicly declared intention. For 2004, it put real GDP growth at 4.6%, and for 2005, 3.6%.

Similar high-riding optimism at the highest level about the U.S. economy was sounded in the U.S. report in the *OECD Economic Outlook*, published in June.

It started, "*The expansion is now firmly established across most sectors of the economy helped by continued stimulus from fiscal and monetary policies. Increases in disposable income induced by tax refunds and wealth gains are providing ongoing support for consumption. The strong growth of productivity and profits bodes well for future investment and output.*" Yet there was a cautious caveat: "*Further sustained weakness in the labor market would, however, pose a downward risk to household income and consumption.*"

Still, it forecast real GDP growth of 4.7% for 2004 and 3.8% for 2005.

Our April letter, written during March 2004, carried the title "Going From Bad to Worse." In its first paragraph, we quoted Friedrich Hayek: *"On the whole, one can say that the practical value of statistical research and business forecasting depends primarily on the soundness of the theoretical conceptions on which they are based. To decide upon the most important problems of the trade cycle remains the task of theory."*

Later in the letter, we continued: *"Apparently, the optimistic forecasts for the U.S. economy in 2004 rest mainly on the assumption that it gained sufficient momentum in last year's second half to be now in a sustainable recovery. Our immediate answer is that a sustained recovery, or more precisely a self-sustaining recovery, needs rather more than just momentum and quantity. Above all, it needs quality in terms of a well-balanced demand and output structure."*

How healthy, in other words, is the current U.S. economic recovery? Without question, this is the most important issue concerning the U.S. economy and even the world economy. Precisely for this reason, it is the biggest bone of contention between the highly optimistic consensus and us.

A PRODUCTIVITY MYSTERY

Looking for clues in history, we have pored over the data of past economic recoveries from recession in the United States. Altogether, America experienced six upturns during the postwar period. They had many features in common, both in speed and pattern. Most striking among them was their extraordinary vigor in employment and income growth. Manifestly, all the recoveries were job and income driven.

Measured from the end of the recession in 2001, the U.S. expansion is now 32 months old. It turns out that private nonfarm payrolls are up only 0.3% from levels reached at the trough of the last recession, in November 2001. In past cyclical recoveries, the increase was on average closer to 7.5%.

According to Stephen Roach, chief economist at Morgan Stanley, private nonfarm employment would be about 8.1 million higher than at present if the current hiring cycle had conformed to the average hiring cycle of the past six upturns. He puts the loss of income in comparison to past cyclical recoveries at $323 billion over these 32 months.

This shortfall in job and income growth is really unbelievable. Is not job and income creation the gist of economic activity? As wage increases are lagging behind accelerating inflation, it seems obvious, fully 32 months into the so-called recovery, that America's working population is seeing no improvement in real wages.

Finding the cause or causes of this protracted employment disaster is certainly the most important question about the U.S. economy. We have to admit to have struggled with this question for a long time. Yet one thing is self-evident to us: This is not cyclical; it is structural.

To this concern, the optimistic consensus has an immediate standard answer: America's extraordinary acceleration in productivity growth is destroying jobs. In one and the same breath, though, it is argued that productivity growth is the single most important source of raising living standards.

According to official data, the business sector's output has soared by 54% since 1992. But hours worked increased only by 16%. The implicit difference between the two is rapid productivity growth. Real compensation per hour rose by 17% over the same period, or about 1.5% per year. That is, hourly wages rose considerably less than the recorded annual productivity gains of almost 3% per year.

That was quite OK until the year 2000. Since then, however, productivity growth has overwhelmingly translated into job and wage destruction. Hours worked by all persons are since down by about 5%, implying enormous cost reductions.

In theory, this productivity effect ought to show alternatively in super-high business profits. But they, too, have not shown up. The corporate profit performance since 1997 has been less than mediocre. There have been complaints that the lack of pricing power is depressing profits. True, inflation rates have fallen; yet they have remained positive, around 2% per year. There was definitely and still is no price deflation.

For us, frankly speaking, America's reported productivity miracle is a mystery, because the implicit big benefits in terms of income and profit growth are not showing up. When all else fails, there is always one last explanation: The problem might lie in the statistical data. That is, by the way, the conclusion economists came to in the 1970–80s, when the data showed persistently poor productivity growth.

Actually, we have an explanation that appears to us pretty watertight: creative lowering of the measured inflation rates through hedonic pricing and other devices. Always keep in mind: One less percentage point in inflation equals one percentage point higher in productivity growth. In other words, GDP growth is grossly overstated. The dismal reality shows in the gloomy employment numbers.

CYCLICAL VERSUS STRUCTURAL

Notwithstanding, this still leaves us with the question of the cause or causes of the protracted employment disaster in the United States. It is a tradition among American economists to attach the greatest importance to the movements of inflation rates, as measured by the price indexes. The fact that inflation had been falling in the late 1990s, even in the face of very strong economic growth, was in their view testimony to the economy's extraordinary health.

Austrian theory, in diametric contrast to this consensus view in the United States, emphasizes the role of monetary and credit excess in creating not rises in the general price level, but structural distortions and imbalances that permeate the whole economy, impairing economic growth over time, even in times of monetary looseness.

Essentially, this first of all raises the question, "distortion" relative to what? In short, relative to the economy's established long-term pattern of domestic demand and output growth.

By international comparison, the U.S. economy has always been notorious for a high rate of consumption and low rates of saving and investment. But this structural pattern went to unprecedented extremes in the late 1990s.

By way of comparison, the net national saving rate — the combined saving or dissaving of households, businesses and the government sector — averaged around 9% of GDP in the 1960–70s, before falling to 5.9% in the 1980s and 4.8% in the 1990s. Its most dramatic fall has occurred since the economy's downturn in 2000: 5.8% in 2000, 3.7% in 2001, 1.7% in 2002 and 1.2% in 2003. This recent steep fall had its main causes in soaring government and consumer borrowing.

Enjoying soaring capital gains in the stock market, private households slashed their savings ratio from around 8–9% of disposable income in the early 1990s to barely 2% in the late 1990s.

Since available resources are limited, this changed the U.S. economy's pattern of economic growth. Personal consumption increased its share of GDP growth over this period to 77%, compared with around 60% in the earlier postwar period and around 67% in the earlier 1990s.

Essentially, such a burst of the consumption component in the GDP draws resources from other components. In effect, it led to a compensating cut in business capital spending and, above all, to an exploding trade deficit.

This is what Austrian theory calls a "structural distortion," meaning basically a divergence in business or consumer spending from the normal long-term patterns in GDP growth. This notion gets a distinctly negative touch through the further assumption that such spending excesses running out of proportion to current income growth cannot last. There essentially comes a point when the perpetrators retrench, either on their own accord or by the force of tight money.

In the past, they never had a choice. Responding to rising inflation rates, central banks pulled the monetary brakes and enforced retrenchment in borrowing and spending. Inherently, consumers and businesses retrenched credit-financed expenditures in particular — mainly consumer durables, residential building, business fixed investment and inventories.

The reaction was always sharp, unimpeded and, precisely for this reason, relatively short. The six prior postwar recessions in the United States averaged just one year with a 2% decline in real GDP.

But these sharp recessions were regularly followed by vigorous recoveries. Once a central bank loosened its reins, those domestic demand components that monetary tightness had curbed took off vertically. In essence, during the recession it created a large cushion of "pent-up" demand that was crucial to propel a vigorous recovery. During the two years after recession, U.S. real GDP growth averaged 5.4% per year.

IT IS TRULY DIFFERENT — BUT NOT FOR THE BETTER

It is most important to realize that the U.S. economy's slowdown over the past few years has nothing in common with the business cycles of the past. Literally everything has been running contrary to the typical pattern of downturn and recovery. It starts with the fact that the sudden nose dive of U.S. stocks and the economy in 2000 clearly had nothing to do with tight money or credit. The two were expanding at ever-new record rates.

What else, then, precipitated their downturn? In hindsight, the superficially plausible explanation is deteriorating profits. Unfortunately, it is an explanation that does not explain why profits were falling during the U.S. economy's best boom years, between 1997–2000, while, by the way, Wall Street was celebrating a profit miracle.

Ever since, persistent runaway money and credit expansion have become the permanent fixture of the U.S. economy and its financial system. Over the three years 2001–03, total credit, available, moreover, at ultra-low rates, rocketed by more than $6,000 billion, yet real GDP was up only $564.3 billion.

Fed Chairman Alan Greenspan and other policymakers like to boast that thanks to their policies, America had its mildest recession in the whole postwar period. This comparison is a deliberate delusion. To judge the success of the employed policies, it is, of course, necessary also to take the economy's performance during the subsequent recovery into account.

As we have repeatedly stressed in past letters, the 2001 recession and the following 2002–04 recovery years add up to the U.S. economy's worst performance in the whole postwar period. But being forever flooded with optimistic comments and forecasts from cheerleaders Greenspan and Wall Street, very few people seem aware of this fact.

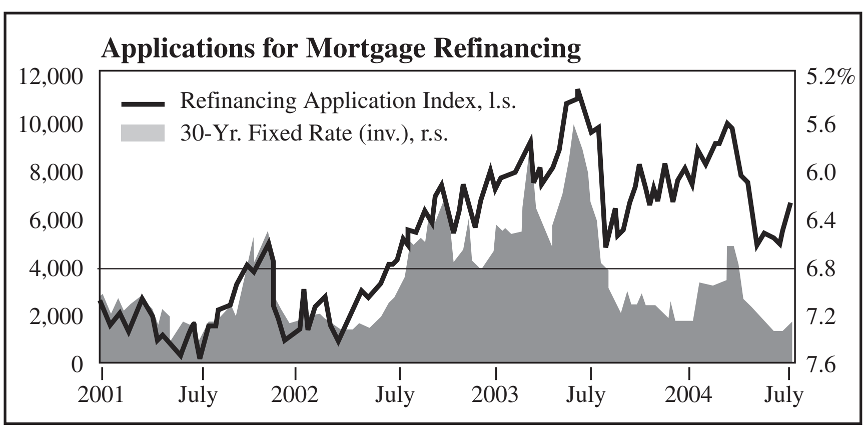
MISSING DYNAMICS

Still, all this belongs to the past. Has this recovery gained the necessary traction to sustain strong growth in the foreseeable future? That is now the key question going forward.

The Fed's answer is a resounding yes. "*In recent months, output growth has moderated and the pace of improvement in labor market conditions has slowed. This softness likely owes importantly to the substantial rise in energy prices. The economy nevertheless appears poised to resume a stronger pace of expansion going forward.*" So ran the statement released after the FOMC's decision on Aug. 10 to raise the fed funds rate to 1.5%.

For the consensus, this was a statement written in stone. For us, it is clear that at this critical juncture, the Fed simply has no choice but to express unbridled optimism about the economy's prospects. Just imagine the panic in the markets if the Fed publicly expressed any doubts about a sustained, strong recovery. Besides, the rise in oil prices refuses to be temporary.

For sure, the oil price is important, yet not all important. Consumer spending has been running into a variety of headwinds. Generous tax cuts and, in particular, the bubble-driven mortgage refinancing boom have been the main drivers of its extraordinary strength in the last two to three years.



Personal taxes fell in the second half of 2003 by $89 billion and increased by exactly the same amount in the first half of 2004. At the same time, equity extraction from the family home through mortgage refinancing has dwindled from a torrent to a creek. In our view, these two items go a long way to explain sharply lower consumer spending in the long run. What is more, both causes persist.

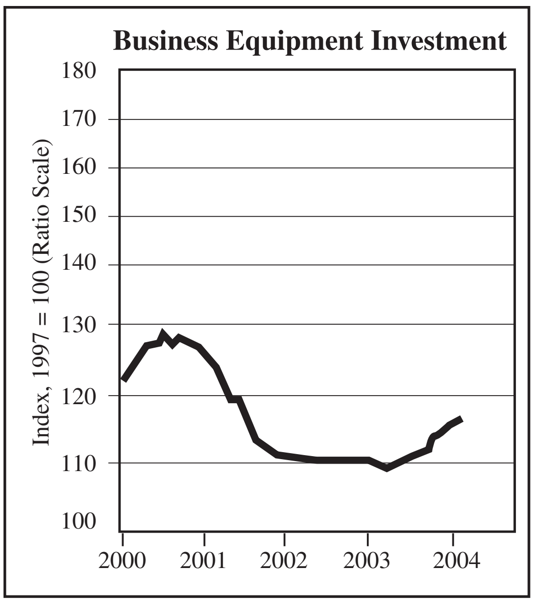
In the end, it all boils down to the question of which particular demand

components are prone to pull the economy forward again. In past business cycles, the recovery after recession always got its extraordinary dynamic from those demand components on which spending had been curbed by tight money. In this way, all recessions ended with a sizable cushion of pent-up demand. These demand components were consumer durables, residential building and business investment in equipment.

The first crucial point to see here is that with no prior pullback in consumer spending, there is no such cushion of pent-up demand this time. To the contrary, ultra-cheap and ultra-loose money and asset bubbles have induced private households to spend with borrowed money, at the expense of the future. Instead of lagging, consumer spending on durables and housing has raced ahead of income growth.

Between 2000 and the second quarter of 2004, U.S. real GDP grew overall by 9.8%. But consumer spending on durables soared completely out of proportion by 23%, and spending on housing by 25.8%. Is this good or bad? Well, for the past two to three years, it was good. The two demand components were major contributors to the recovery since 2001. But for the coming years, it is very bad, because this frenzied spending with borrowed money has implicitly stolen from future demand and future production.

It has to be considered that these two components of consumer spending have always been pivotal in propelling the regular, vigorous recoveries from recession. The two represented the greater part of the pent-up demand. Pondering the U.S. economy's present growth prospects, it is a chief consideration for us that such pent-up demand is completely missing this time.



It is, moreover, widely understood that keeping strong U.S. economic growth on track will require a big contribution from the business sector in the form of sharply higher capital investment and hiring, providing indispensable job and income growth. Consensus reports are conveying the impression that, mainly thanks to surging corporate profits, the investment boom is well on its way.

As usual, we check the gauges and, also as usual, we find something quite different. For sure, business fixed investment has sharply recovered from its low in the first quarter of 2003. Yet looking over the full period since the start of the U.S. economy's downturn, we note that nonresidential fixed investment still has not quite recovered to its level in 2000. Two most important components are lagging dramatically. Industrial equipment is down 13%, and transportation equipment is down even 22%.

The sole bright spot in the investment statistics is the high-tech information component, with a 19% rise between 2000 and the second quarter of 2004, owing overwhelmingly to its computer component, up 84% in real terms.

But this needs a comment. If measured in current dollars, businesses raised their spending on computers over these years minimally, from $101.4 billion in 2000 to $109.1 billion, annualized, in the second quarter of 2004. More than 90% of the big spending boom on computers, as recorded in chained dollars, derived from hedonic pricing.

Keep in mind that hedonic pricing is a statistical adjustment added to reflect the government's view of how much computational power businesses get for their money. From an economic perspective, it is money that nobody spent and nobody received. However, it increases real GDP and, in the same vein, productivity growth. Yet it is clearly an investment boom that adds little or nothing to jobs and incomes.

THE CONSUMER SURPRISES

The U.S. economy grew at a 3% rate, annualized, during the second quarter, according to the Commerce Department's advance estimate, after expanding at a 4.5% rate in the first three months of the year. Consumer spending grew at an annual rate of 1%, a sharp slowdown from 4% in the first quarter.

When it raised its federal funds rate by a quarter point, to 1.5%, the Federal Reserve said that it saw the moderation of output and employment growth in recent months as a result, in large part, of the rise in energy prices, but that *"the economy nevertheless appears poised to resume a stronger pace of expansion."* For sure, this belongs to the most important questions at this point.

How soft, and for how long? To our great surprise, the following discussion about the weakness in consumer spending focused narrowly on one single month: June. Listening to the Fed chairman, the June data were a mere breather, a small bump in the road, and not the leading edge of a new, prolonged economic slowdown.

The June numbers were, indeed, horrible. Total consumer spending on goods and services fell during the month in real terms by $67.9 billion, or 0.9%. It has been rightly argued that it is not unusual for economic growth to be uneven during periods of expansion. In this case, it had its obvious reason in the fact that the automobile industry had boosted their May sales by heavy promotions. As always, the following month showed sharply lower sales. Below are the monthly spending numbers for the four months February–June.

REAL PERSONAL EXPENDITURES
% CHANGE FROM PRECEDING MONTH

	FEBRUARY	MARCH	APRIL	MAY	JUNE
TOTAL	29.2	4.8	-2.6	47.3	-67.9
DURABLE GOODS	15.7	6.1	-21.1	39.3	-63.6
NONDURABLE GOODS	1.8	7.2	-5.2	6.3	-4.3
SERVICES	13.6	-7.3	19.7	7.7	0.1

SOURCE: DEPARTMENT OF COMMERCE, *PERSONAL INCOME AND OUTLAYS*

Much ado is meanwhile made of the fact that retail sales rebounded in July. Of course they would. After auto sales imploded in June, automakers promptly ratcheted up sales incentives again, and sales improved.

To make sense of the sharp fluctuation between May and June, the simple thing to do, of course, is to lump the two months together. The result is a net decline of overall consumer spending during the two months by $20.6 billion, following a small decline in April by $2.6 billion and a moderate rise by $4.8 billion in March.

According to these figures, real consumer spending actually shrank in the second quarter of 2004 by $23.2 billion, while in the GDP accounts it rose by $19.5 billion. Both, by the way, have the same source. Ominously, the sudden weakness shows also in consumer spending on nondurable goods and services.

Economists at Goldman Sachs have calculated that energy spending does not represent a large enough proportion of household budgets to explain the slowdown in consumer spending from about 4% in the first quarter to just 1% in the second. In their view, it could account for no more than half a percentage point of the 3% change. A more plausible explanation for them is that the termination of the tax cuts and the mortgage equity withdrawal played the decisive roles.

THE STRUCTURAL CONUNDRUM

For us, this sudden weakness in consumer spending hardly comes as a surprise. It has taken an unprecedented dose of fiscal and monetary stimulus to spark any semblance of an economic recovery. But lacking any organic job and income creation, economic growth became hostage to an extraordinary array of asset and credit bubbles.

Recessions are, in essence, the phase in the business cycle in which businesses and consumers unwind their spending excesses during the boom. Not so this time in the United States. Fighting the economy's downturn for a protracted period with ultra-low interest rates and ultra-loose money, the Federal Reserve unleashed unprecedented credit excess. In essence, it fought the adverse fallout from past excess by still more and greater excess.

Key to the U.S. economic recovery during the last two to three years were rock-bottom short-term interest rates pegged by the Fed, unrestrained credit and debt creation and a prolonged rise in stock and house prices. While job growth and the associated income growth crashed, private households nevertheless maintained their spending, using the rising house prices as collateral for a borrowing frenzy. U.S. policymakers joined to hail the miracles of boundless "wealth creation" taking place in this way.

The net result of these policies has been an economy that remains stuck with grossly excessive consumer spending and grossly excessive financial speculation, but grossly inadequate business investment in productive plants. What it crucially needs for a self-sustaining economic recovery is a shift in its pattern of growth away from consumption and toward productive capital investment. It has not happened, and it is not going to happen.

WHAT NEXT?

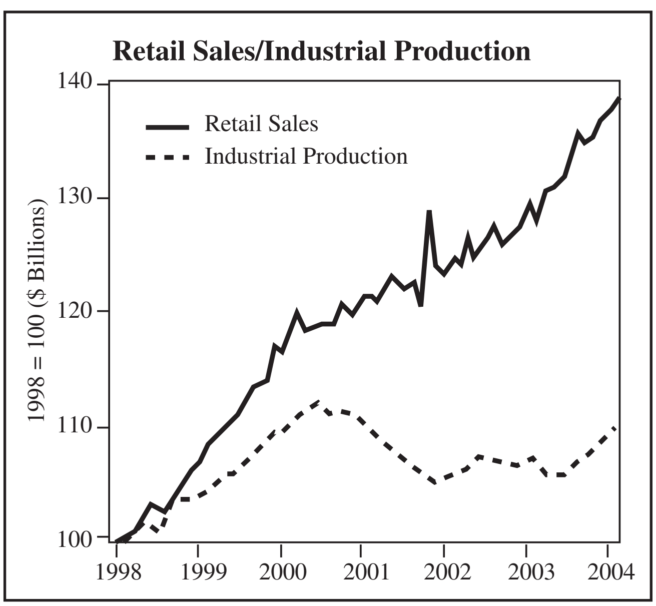
We come to the most urgent question about the U.S. economy at this juncture: Is it stalling out, or is it resuming its strong growth, gaining traction for a self-sustaining expansion with healthy job and income growth?

In the consensus view, the economy's weakness in the second quarter was nothing more than a "soft patch." We are no less sure that "traction" will remain elusive. It is the essential outgrowth of an upturn that has been of miserable quality right from the start.

With its advance estimate of GDP growth in the second quarter of 2004, the Commerce Department's Bureau of Economic Analysis also released benchmark revisions to the national accounts data back to 2001. Notable adjustments include a markedly lower personal savings rate and a downward revision to economy-wide corporate profits for the past couple of years.

The biggest surprise in the GDP data was the reported sharp slowdown in consumer spending to just 1% at annual rate. But what about the other major demand components: business fixed investment, residential construction and inventories? Most important next to consumption is, of course, business fixed investment. In the consensus view, business investment spending continues to post healthy gains, thanks to exceptionally strong profit growth in the past two years. We have strong reservations about both the strength of investment spending and the exceptionally strong profit growth.

Over the full year to the second quarter, nonresidential fixed investment rose by $108 billion, a remarkable rate of about 10%. That is, in fact, a healthy gain. But as already pointed out, the stellar aggregate number conceals an unusually lopsided investment pattern. The outstanding contributor is computer investment, thanks to hedonic pricing. Investment in industrial equipment, the key component for industrial production, was virtually stagnant over the year.



In addition, the accelerated depreciation allowance for capital investment spending that was part of the last tax package will expire at the end of this year. If businesses have pulled forward investment projects from 2005 into 2004 to qualify for the tax break, investment spending might slow sharply after the turn of the year.

THE PROFIT DRAMA

Another highly popular argument of the bulls is the U.S. economy's excellent profit performance in the past two years, as trumpeted by most Wall Street analysts. Here again, we must plead to keep things in perspective. Overall corporate profits peaked in 1997 and hit their low in the fourth quarter of 2001, virtually the end of the recession.

Our focus is always on the profits of the nonfinancial sector. At their high in 1997, they amounted to $504.5 billion. In the first quarter of 2000, just before the start of the economy's downturn, they were down to $426.2 billion. At their low, in the fourth quarter of 2001, they amounted to $236.5 billion. In the first quarter of 2004, they had recovered to $420.7 billion.

From the low to the new high, they increased by 77%.

Given the simultaneous steep fall of share prices, this number certainly has a highly bullish flavor. On closer look, the steep rise was rather more bearish than bullish. First of all, the profit level of the first quarter of 2000 was manifestly nothing to crow about. It ushered in the economy's downturn. Drawing this comparison, a further point to be taken into consideration is that today's nominal GDP is up almost 20% since then. In 2000, those profits were equivalent to 4.4% of GDP. Presently, they are 3.6%.

Bearing the structural distortions in the U.S. economy in mind, a most important aspect is the changes in profits between different sectors. They are, really, the numbers that matter most. For us, most striking, and also most telling, is the difference in the profit performance between manufacturing and retail trade. In 1998, manufacturing earned $157 billion, far more than retail trade, which earned $66.4 billion. But just six years later, in the first quarter of 2004, manufacturing profits were drastically down to $81.5 billion and retail profits sharply up to $80 billion.

CORPORATE PROFITS BY INDUSTRY (BILLIONS OF DOLLARS)

	1998	1999	2000	2001	2002	2003
MANUFACTURING	157.0	150.6	144.3	52.6	50.7	67.3
DURABLE GOODS	83.4	72.3	60.0	–25.4	–8.3	–3.5
MACHINERY	15.6	12.4	8.2	2.7	1.6	–0.5
COMPUTERS & ELECTRONIC PRODUCTS	3.9	–6.5	4.0	–48.5	–32.9	–15.4
ELECTRICAL EQUIPMENT	6.1	6.3	5.6	1.9	–0.2	–3.2
MOTOR VEHICLES	6.4	7.3	–1.0	–9.2	–6.0	–6.2
NONDURABLE GOODS	73.6	78.3	84.3	78.0	58.9	70.2
FOOD AND BEVERAGE	21.8	30.7	25.4	28.0	24.1	27.7
PETROLEUM AND COAL PRODUCTS	4.9	1.8	26.9	29.6	4.0	14.8
CHEMICAL PRODUCTS	25.1	23.0	14.2	12.6	17.1	21.2

SOURCE: DEPARTMENT OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, TABLE 6.16D

There is a similar drastic divergence in profit performance within the manufacturing sector. Profits of the producers of consumer durables and capital goods have generally collapsed into persistent losses. In 1998, they earned a collective net profit of $83.4 billion, accounting for more than 50% of total manufacturing profits. By 2000, this had shrunk to $60 billion. But in 2003, a year of recovery, they ran a collective net loss of $3.5 billion.

It is most important to realize this extreme divergence in the U.S. economy's profit performance because it is symptomatic of the marked, structural distortion that has been going on in the U.S. economy. Most remarkable, certainly, is the persistent savage profit deflation of the producers of high-tech equipment, unquestionably due to fierce competition. It is needless to say that persistent losses are prone to choke new investment.

Yet most conspicuous from a macro perspective is the flagrant diversion in the development of profits between manufacturing and retail trade. We looked back into the mid-1980s and noted that manufacturing profits were then about four times those of the retailers. Today, they are equal. That is, of course, what has to be expected in an economy in which consumer borrowing and spending reign supreme.

CRISIS IN CAPITAL FORMATION

Pondering the U.S. economy's past and future performance, we remain above all puzzled by the extraordinary

job calamity. In our view, more than anything else, it reflects the true economic reality. For us, the better-looking GDP and productivity data are statistically bogus. There seems to be a general complacent supposition that the U.S. economy's further strong growth will also solve this problem. In the end, it all comes back to the overriding perception that the U.S. economy is endowed with sound fundamentals and an extraordinary flexibility.

Though we, too, have no ready explanation for the disastrous job performance in the United States, it is our strong assumption that it has its main cause or causes in the structural distortions that its economy has been exposed to in the past several years. It is customary to eulogize the beneficial effects of the policy stimulus to consumer spending, but this benefit did not come without costs. It had its malign counterpart in three major macroeconomic maladjustments that tend to thwart further recovery: a collapse of national saving, weaker capital spending and an exploding trade deficit.

Economics is about the use and allocation of limited resources — physical resources for production, by the way. In a world of limited resources, an increase in consumption as a share of GDP essentially decreases the share available for capital spending. That is what has happened in the United States, showing dramatically in the collapse of national saving.

From a macro perspective, saving from current income means the release of resources from the potential production of consumption goods for the production of capital goods, to be used for the improvement or the expansion of the economy's capital stock. National savings are, in essence, the measure of the resources that an economy has available for capital formation. In reverse, available savings set the physical limits to capital investment.

It is a historical truism that strong investment in tangible assets — plant, machinery and commercial and residential building — is the most important source of an economy's growth in output, in employment and in wealth. For generations of economists, capital investment was ultimately the most important component in the economic growth process. But they knew also that to make a high rate of capital accumulation possible, it needs a high level of saving.

The outstanding feature of the U.S. economy's performance in the past seven to eight years has been a prolonged, phenomenal decline of saving. As stated earlier, national saving equaled 5.8% of GDP in 2000, when the economy's downturn started. Soaring government and consumer borrowing has radically slashed the savings rate in the following years. The most recent rate was 1.2% of GDP. And what happened to the allocation of resources during these years of massive dissaving?

In the second quarter of 2004, real GDP was up 9.8% from 2000. Within the GDP, it was more of the same familiar distortions: government spending up 13%, consumer spending up 12.2%, exports up 3%, imports up 14%. But nonresidential fixed investment was down 2.7%. We are sure that this pattern of economic growth completely lacks the quality needed for self-sustaining growth.

What is more, net investment (after depreciations) in the nonresidential sector has effectively slumped. It peaked in 2000 at $404.8 billion. In 2003, it amounted to $154.5 billion. In other words, capital spending in the sector has been falling badly short of depreciations in the existing capital stock.

And now, once more, to the vexing problem of structural distortions in the economy. While net investment of firms in the nonresidential sector collapsed, net residential investment soared to a record high, surging from $283.3 billion in 2000 to $376 billion in 2003. From the macro perspective, the first is an obvious case of underinvestment, and the second an equally clear case of overinvestment and malinvestment.

What, then, has been causing the U.S. economy's protracted job disaster? We see two main causes. One is a gross lack of domestic investment in plants and equipment, and the other is soaring imports of consumption and capital goods from Asia. Consider that one-third of retail sales in the United States is now covered by imports. Of course, that costs U.S. jobs. It strikes us as most ominous that the import surplus has kept rising even in the face of slower U.S. demand growth and large idle capacities.

THE GREAT MICRO PROFIT ILLUSION

One obvious reason is, of course, the extraordinary competitiveness of the Asian producers operating with

extremely cheap labor and undervalued currencies. But we think there is more to this development than just foreign competition. We suspect another main cause on the part of the United States. That is the new corporate culture, having unleashed a frantic pursuit for easy and quick profits predominantly through cutting costs, above all labor costs. At the same time, buying factories through mergers and acquisitions has taken precedence over building factories through new investment and hiring.

As we have already elucidated several times in past letters, these strategies may appear most alluring from the perspective of the single firm, but they are self-defeating from the macro perspective, which focuses on effects on the economy as a whole.

Cutting wage expenses tends to increase a firm's profits. Accordingly, it is commonly believed that when firms throughout the economy do the same, they improve aggregate profits. But there is a logical snag in this assumption. For the whole business sector, this means reducing revenues as well as expenses. Lower wages and salaries mean lower personal income and, therefore, less personal spending on the goods and services sold by businesses.

In November 2002, we read in *BusinessWeek* that with sluggish corporate revenue growth, companies in the Standard & Poor's 500 stock index may have to cut as many as 900,000 jobs, or 4% of the labor force, to boost profits by 12%. The report ended with the remark: *"Rebuilding profits, especially quality profits, will take pain. But profits are the lifeblood of a market economy and the key to sustained growth. There's no alternative."*

It has become manic in economic thinking in America that sacking labor and cutting wages is the surest and fastest way to higher profits and higher stock values, the new, paramount measure of corporate success. The very same illusion looms behind the merger-and-acquisition mania, supposedly boosting profits and shareholder value through synergy effects. The true name of the game is, of course, wage cutting.

Very few of the mergers and acquisitions have actually proved successful even for the firms directly involved. Strikingly, never is the question of their impact on the economy as a whole posed or discussed. For us, it has always been self-evident that it must ultimately be damaging for economic growth. The obvious, simple reason is that mergers and acquisitions must at least be partly at the expense of organic growth through new investment and hiring.

The following quotation happens to be from John M. Keynes, but it could be from any other economist since Adam Smith: *"It is investment, i.e. the increased production of material wealth in the shape of capital goods, which alone increases national wealth."*

THE TRADE CRISIS

We come to America's other big job killer — the monstrous trade deficit. In 2003, the United States ran a trade deficit in goods of $549.4 billion, roughly equal to 5% of GDP. Exports amounted to $713.7 billion and imports to $1,263.1 billion. The deficit was $198.1 billion in 1997. Such a deficit essentially means an addition to the goods available for domestic consumption or investment.

It is often argued that the large capital inflows financing this deficit are America's substitute for its lacking domestic savings. But what are the capital inflows truly financing in the U.S. economy? Domestic savings from current income implicitly reduce the spending on consumption in favor of investment spending.

Manifestly, the U.S. capital inflows do nothing of that kind. Going overwhelmingly into Treasury and agency bonds, they finance government and consumer spending. So-called direct investments by foreign firms played a major role in the late 1990s, but what truly happened was foreign buying of existing plants through the share market, not building of new plants.

In short, these capital inflows have been financing and continue to finance mainly two things in the U.S. economy: consumption and asset price inflation, but definitely not capital investment.

The cause or causes of these endless trade deficits is the other vexing question. The official and the generally favored explanation in America is that they have their main cause in the eagerness of foreign firms and investors to acquire U.S. assets, offering the best returns in the world. Under a system of flexible exchange rates, the necessary dollars for the foreign investors become available through a correspondingly large U.S. current account deficit.

Mathematically, this equation is correct. Yet economically, it is complete nonsense, because this equation says nothing about underlying causalities. Capital inflows and a rising dollar are definitely not prone to have created the protracted consumption boom in the United States.

For sure, foreign private investors have been expecting higher returns on their dollar assets, But the truth is that these expectations been grossly disappointed. The great irony, after all, is that foreign investors are earning on their U.S. assets of around $9 trillion less than American investors are earning on around $6.5 billion in assets held abroad.

For good reasons, private capital flows into the United States have slumped in the last few years. But this has been offset by Asian central banks. In 2002, foreign central banks stepped up their dollar purchases to $351.9 billion, from $112.3 billion in the prior year. In 2003, their dollar purchases jumped to the unbelievable amount of $616.6 billion.

Basically, a rising trade deficit reflects the fact that domestic spending in the country concerned is exceeding domestic output by precisely its amount. This raises two questions: *first*, what is the cause of the sharp acceleration in U.S. domestic spending; and *second*, what is the cause of the lagging U.S. output?

Rising capital inflows explain a rising dollar and also certain effects on exports and imports, but they definitely do not explain a chronic and massive excess of domestic spending over domestic output, which has developed in the United States over many years.

Of the three main components of domestic spending on goods and services — private consumption, business fixed investment and government spending — private consumption alone has been grossly out of step for years, growing persistently faster than GDP. Clearly, consumer spending is the main culprit. Lately, though, it has been joined in this respect by sharply rising government spending.

And what has been the cause of this protracted consumer spending excess? In short, ultra-low interest rates and ultra-loose monetary policy fueling virtually limitless credit creation. Lacking the traditional support from employment and income growth since 2000, consumers have extracted purchasing power from yet another asset — their homes.

This leaves us with the question of the lagging domestic output. Here, too, its main reason is all too obvious: badly lacking investment spending, particularly in manufacturing. Overall, the trade gap is largely an imbalance in the trade of manufactured goods. The apparent problem with the monetary ease is that it has very disparate effects on the economy. Consumer spending and asset prices have been highly responsive, as opposed to highly unresponsive investment spending.

Pondering the trade deficit's main causes, one other question has been uppermost in our mind. It is the question of whether these causes are being remedied and are receding. We have to say that we see absolutely nothing of that kind.

We think, in fact, that the necessary structural changes in the U.S. economy cannot come from government policies. They have to come from changing preferences of consumers and businesses. The consumer has to rediscover saving from current income, and businesses have to rediscover organic growth through new investment and hiring. There is no free lunch.

THE UGLY ALTERNATIVE

We realize that policymakers and consensus economists in the United States do not see any need for such changes. In their view, the trade deficit and its financing is no problem for the United States, since foreign investors are eager to invest in U.S. dollar-dominated assets.

In addition, there is the safeguard of foreign central banks. Wanting to avoid the appreciation of their currencies and the disappearance of their export surplus, they are compelled to purchase dollar assets. Intrinsically, the capital inflows help to keep a lid on U.S. interest rates, while the rapidly rising imports importantly help to keep a lid on the U.S. inflation rates.

Amazingly, policymakers as well as economists in the United States never mention that the trade deficit exerts

two major adverse effects on the economy. A rising U.S. import surplus means more jobs, more corporate profits and more economic growth throughout the rest of the world, mainly Asia, but at the expense of American jobs, profits and growth.

With its protracted surge and current tremendous size, the trade deficit has been and continues to be a major destroyer of employment and profits in the United States. What's more, these destructive effects are concentrated on one single sector of the economy — manufacturing.

The other day we read an article in *BusinessWeek* headlined, "When a Wider Trade Gap Is a Good Thing." The short answer: "*Surging imports are helping to keep inflation forces in check.*" The truth is they only suppress inflation, but at the price of ravaging the manufacturing sector.

CONCLUSIONS:

The Fed and the consensus are highly optimistic about the outlook for the U.S. economy's growth. The rationale, as contained in the minutes of the latest FOMC policy meeting, is that the considerable monetary and fiscal stimuli of the past keep the economy moving at a satisfactory clip. In addition, sharply higher profits are supposed to support continued strong growth in investment spending. The resulting gains in employment will, in turn, bolster consumer spending.

We disagree vehemently, for four reasons:

First, two major sectors that have normally led the U.S. economy out of recession — consumer durables and housing — have already done their heavy lifting. The problem is that they have done so during the past few years, in sharp contrast to declines in past recessions.

Second, business fixed investment has rebounded, but far too weakly to pull the economy forward.

Third, consumer spending has been flat for at least four months. This suggests a lot more than a "soft patch."

Fourth, economic data released during the past few weeks overwhelmingly indicate a slowdown of U.S. economic growth.

The burning issue for the U.S. economy and the world economy now is whether all this will add up to a brief and minor deceleration in economic expansion or to the harbinger of a more serious economic slowdown.

In the consensus view, the main risk to the global economy is a sustained high oil price. Its recent fall seems to solve the problem. In our view, the sudden, sharply slower U.S. consumer spending has its obvious main cause in the fact that tax cuts and the mortgage-refinancing boom have spent their force on the demand side. Other dynamics to keep the economy's recovery on track are not in sight.

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